Committee on Small Business and Entrepreneurship
United States Senate

"Reauthorization of Small Business Administration Programs"
April 26, 2006

Written Testimony
Of

James A. Maxwell
504 State Manager
Granite State Economic Development Corporation/
New England Business Finance

Introduction

Madame Chair, Ranking Member Kerry, and members of the Committee, thank you for inviting me here today to provide my testimony regarding the Local Development Company Program or, as it is more commonly called, the SBA 504 Loan Program. My name is Jim Maxwell and I have been a hands-on SBA 503/504 Loan Program practitioner since 1981. Over the last 25 years I have been active in Certified Development Company (CDC) management, marketing, loan structuring, credit underwriting and documentation. Currently, I am Maine's 504 State Manager for Granite State Economic Development Corporation which does business as New England Business Finance in Maine and Massachusetts. We are the region's leading SBA 504 Certified Development Company and, currently, the nation's 7th most active 504 lender.

Our Certified Development Company

Granite State was originally certified in 1982 in three New Hampshire counties and then expanded statewide in 1987. In 2003, when positive SBA regulatory changes created Local Economic Areas (LEA) and statewide certifications, Granite State Economic Development Corporation (GSDC) d/b/a as New England Business Finance expanded into Maine. Although our CDC was new to Maine, I had been working with one of the regional development companies and was responsible for more that 80% of the state's 504 Loan production since the early 1990s. At the same time, Granite State received the Small Business Administration's permission to include the northern tier (3 counties) of Massachusetts as a Local Economic Area. Since 2003, Granite State d/b/a New England Business Finance in Maine (a statewide CDC) and Massachusetts (an LEA) have become the region's fastest growing local development company. Earlier this month, Granite State Economic Development Corporation/New England Business Finance received approval from the SBA to expand (through the LEA process) into seven counties in Vermont. As in New Hampshire, we have local offices with professional staffs in Maine and Massachusetts. Within 60 days, we will open a new, professionally staffed Vermont office.

Our 504 Loan Portfolio

Granite State Economic Development Corporation/New England Business Finance, like hundreds of CDCs working on a local, regional or statewide basis, is proud to have assisted thousands of small businesses in accessing the capital they need to expand and create jobs. Since 1982, we have provided loan approvals to 1,738 companies for $608 million in 504 debentures while participating banks have provided an additional $975 million as the first mortgage/first secured lender. Within the next two months Maine's New England Business Finance is on pace to reach the one hundred 504 Loan threshold since certification. On a portfolio-wide basis, Granite State's assisted companies have created and retained approximately 15,000 jobs. On a per capita basis, we have been the most active CDC in the country since 1992 and we continue to be New England's most active 504 lender. Of the 17 active CDCs in New England, Granite State accounts for 30% of the total 504 activity. Our portfolio has a Currency Rate of 96.5% and consists of start-up (4.0%) and existing (96.0%) businesses. Our portfolio companies come from nine major industry groups with the highest sector concentration in Service (26%), Manufacturing (14%), Hospitality (12%) and Professional (11%). Our active loan portfolio includes participation with 35 New England banks. Each month we reach out to dozens of lenders, small businesses and economic development professionals to keep them informed about the benefits of the SBA 504 Loan Program.

Local Development is Working

As with our colleagues at hundreds of CDCs across the country, our mission and responsibility is to deliver this powerful federal financing program to small businesses in our local communities. The Small Business Administration's (SBA's) 504 Loan Program has its roots in the Small Business Investment Act of 1958, a law that authorized the formation of "local development companies" to be "principally composed of and controlled by persons residing… in the locality". Those local development companies were, and still remain, a major catalyst for small businesses needing to access fixed asset financing. In that regard, the local development companies (now called Certified Development Companies or CDCs) have served the law's purpose of bringing together local banks, chambers of commerce representatives and government officials to focus on local community development. Each year, Granite State Economic Development Corporation/New England Business Finance works closely with at least 100 state, county, city and town economic development professionals to accomplish our "community's" goal to assist local businesses and create jobs.

Today, the 504 program is an important mechanism for providing fixed asset financing to the nation's business community. For FYE September 30, 2005 the 504 Loan Program assisted more than 9,000 small businesses by providing approximately $5.1 billion of SBA debenture loans while leveraging at least $6.5 billion in conventional bank loans. In FYE 2005, the 504 Loan Program experienced a 10.1% increase in the number of small businesses loans approved and a 26.5% increase in the amount of debenture funding accessed by expanding companies. Certified Development Companies are now economic development organizations that support growth in regions that range from a single county in one state to a multi-state region. Over the past 25 years our industry has matured and gained the trust of both SBA and Congress to implement and manage a multi-billion dollar industry. Each successive year, the CDC industry has proven that it can adhere to strict ethical and financial regulations while effectively delivering a powerful economic development program to our country's businesses.

Recent SBA Strategies are Working

Since 2003, the SBA has implemented two very important strategies to improve the 504 program. First, the centralization of 504 loan processing in Sacramento, California has standardized the way in which SBA 504 rules and policies are applied nationally. Second, the creation of Local Economic Areas and multi-state areas of operation have allowed CDCs to reach out to its expanded "local" market area as a logical geographic extension of CDC services. Our industry has embraced these SBA strategies as evidenced by positive growth in the number of businesses assisted and the amounted of funding accessed. For example, in fiscal year 2003, the 504 Program provided approximately $3.1 billion in 504 funding to small businesses while in the current fiscal year 504 funding is projected to reach the $6.0 billion level. Over the years, the Certified Development Companies have consistently met the demands for continued loan growth challenge while maintaining ethical and professional management practices. In return, the SBA has bestowed on CDCs more authority to process, approve, close and service small business loans. The CDCs have earned the trust of the SBA, Congress and small business.

Proposed SBA 504 Legislation

If good things come in small packages, then great things come in the legislation proposed by Senator Snowe in S2162. Beyond the increased reauthorized funding levels for 2007 and 2008, the proposed 504 legislation contains language that provides both clarification and enhancement to a number of important components of the regulations. I would like to share with you my position as a SBA 504 Loan Program practitioner on a number of the sections contained within the proposed legislation.

<u>Liquidation</u>

Since the program's inception in 1980, the primary functions of a CDC were to market, underwrite, close and service loans. For a considerable period, delinquent 504 loans were turned over to the SBA for foreclosure and liquidation. As the industry began to mature, many CDCs became increasingly involved in both the workout and liquidation of 504 loans. With the recent introduction of proposed regulations on liquidation by SBA, it is clear that CDCs will be given full liquidation responsibility for their 504 portfolio. I support the transfer of the liquidation function to CDCs and believe our industry will be effective in maximizing loan recoveries. However, I believe it is important to note that this function is often time-consuming, complex and costly. Since most CDCs are non-profit, economic development organizations, their revenue sources and cost structure are not sufficient to cover the added costs of loan workout and liquidation. Furthermore, some in our industry will be on a learning curve and will need the option to contract out this function until such time as they have developed their own in-house expertise.

The proposed legislation, in my opinion, allows for each of these objectives. It allows CDCs directly, or under contract to qualified third parties to perform the foreclosure and liquidation function. The legislation also permits CDCs to be both reimbursed for expenses and compensated for results based on a percentage of the net amount recovered.

<u>Additional Equity Injection</u>

The proposed legislation takes a significant step forward in meeting the spirit of our economic development program while maintaining good underwriting practices. Requiring a higher equity injection for "single purpose" and "new business" loan projects is an accepted credit practice in lending. But using equity funds in excess of required levels to reduce the 504 loan has the effect of limiting the borrower's access to a long-term, fixed rate of interest while maintaining a higher level of first mortgage bank debt. By allowing the borrower to use excess equity funds to reduce the first mortgage lender's loan provides the borrower with a lower, more predictable debt service while improving the SBA's collateral position by reducing the amount of first mortgage debt. The current regulations are confusing to both small businesses and our lending partners.

<u>Low-Income Areas</u>

The inclusion of assistance to small businesses located in "low-income areas" as a Public Policy Goal validates what most program practitioners have been focusing on for decades. When I started with the prior 503 Loan Program in downtown St. Louis in 1981, we used the program to attract businesses back to our city, back into our vacant buildings along the Mississippi River so that our low-income population would have access to jobs and a decent wage. Over the last 25 years, as the location of "low-income" populations has shifted and our economy has changed, so has the need for our 504 Loan Program. Every month in Maine we learn that a major paper mill, clothing manufacturer or other major employer has shutdown or shifted production to another country. Overnight, good paying jobs are gone and a new group of "low-income" Mainers has emerged. Other states and other cities have their own sad job-loss stories. Declaring assistance to businesses located in "low-income areas" as a 504 Program goal sends a clear message to companies and citizens that we are here to help – if, when and where needed.

Goal Combination

Every CDC is mandated to qualify every SBA 504 Loan Program project for eligibility based on the facts associated with the owners, the type of business and the project components. From time-to-time, a worthy small business does not meet either our program's job creation threshold or public policy goals and we are unable to provide assistance. The proposed legislation allowing individuals who, in the aggregate, own at least 51% of the small business applicant and who qualify under one or more of the program's public policy goals will provide more program access for otherwise good and worthy companies.

Maximum 504 and 7(A) Eligibility

Often good companies that have grown with assistance under the 7(A) Program may need a 504 loan to purchase or construct a new facility or to acquire equipment. Under current regulations, once the borrower reaches the maximum eligible funding in one program, it is ineligible to receive assistance from the other SBA program. The result is that many companies are forced to invest scarce working capital into fixed asset expansion projects to overcome the lack of 504 funds available due to fund eligibility restrictions. The effect of the current regulation is an impairment to an otherwise strong borrower. This proposed enhancement in the regulations is one of those "it just makes sense" changes.

Refinancing

One of the only things growing faster than the SBA 504 Loan Program is the cost to construct a new building. In recent years, more CDC applicants are deciding to expand their current building (rather than construct a new facility) and, typically, the mortgage used to acquire the property has an outstanding balance. Under the 7(A) program, refinancing is an eligible project cost as long as there is a 20% "cash flow benefit" (either through increased loan term or reduced interest rate) to the borrower. Under current 504 regulations, refinancing is not an eligible "project cost" although a bank's existing first mortgage can be combined with the bank's new 504 mortgage. In those instances when the bank's existing and new mortgages are combined, the SBA 504 debenture loan is then subordinated to the new combined bank first mortgage. Over the years this has been a good "work around" solution to address the "no refinance" eligibility issue by actually allowing a refinance but without using SBA 504 funds. This practice has been an acceptable solution but it is does not provide the best result. The effect of the current regulation is to "push" the SBA 504 debenture further back on the collateral with no real economic benefit to the borrower. The proposed regulation to allow for the inclusion of an existing mortgage as an eligible project cost (as long as the existing indebtedness does not exceed one-half of the project costs of the expansion) is another "it just makes sense" solution. With the proposed change, the small business can access more funding at a lower fixed interest rate while the SBA reduces the amount of bank debt in front of the debenture on the project collateral.

Fees

Over the years it has been the responsibility of the CDC staffer to deliver the news about our program's "new" fees or "higher" fees and sometimes (but rarely) "lower" fees to our lending partners and our 504 borrowers. In the case of the third party lender participation fee (equal to 0.5% of the bank's first mortgage or secured loan), the CDC has had to change the explanation to lenders and borrowers depending on SBA policy at the time. At first, when lenders could not "pass on" the half point fee to borrower, they would either increase their bank's commitment fee or the interest rate on the loan. When SBA policy changed to allow the bank to charge the borrower for the participation fee, the borrower considered this a "higher" out-of-pocket cost to use the program. Some CDCs, like Granite State Economic Development Corporation/New England Business Finance, decided to pay half of the bank's participation fee as part of its marketing and outreach strategy to attract both lenders and borrowers to the 504 program. The proposed regulation to eliminate the "Participation Fee" and increase the "Development Company Fee" by 0.06% will further reduce the barrier to the program access for banks and borrowers. Since Granite State Economic Development Corporation/New England Business Finance has already been absorbing half of the participation fee at loan closing, the real impact of the fee shift to our CDC is not as dramatic. Historically, any 504 Program regulation or policy change that has reduced cost to the bank or borrower has correspondingly increased loan activity and access to the program.

Use of Excess Funds

Our CDC is a non-profit organization whose mission is to provide access to long-term, fixed interest rate financing for worthy small businesses seeking to expand and create jobs in our local areas. Like most CDCs, our organization is made up of individuals who live in each of the states we serve. The geography of New England allows for an interesting twist on the perception of "local". In the current year, New England Business Finance has processed several 504 loans in Aroostook County (known in Maine as "The County"). "The County" is a 5 to 6 hour drive from Portland, Maine but it is considered and treated as our "local" area. We interact with our "County" bankers, borrowers and other economic development professionals on a weekly, if not a daily, basis. In the amount of time it takes to drive to Aroostook County, I can traverse 4 states to be in New York City, have lunch, and be headed back to Maine. From Maine, I can travel 14 miles south through New Hampshire into Massachusetts in less than an hour. Many Maine residents work in Massachusetts and New Hampshire. Many New Hampshire companies have branches or satellite operations in Maine and Massachusetts. The definition of "local development" gets blurred in the description. Often a company that we assist in New Hampshire or Maine will create jobs for residents from other states that we serve. Historically, our organization has re-invested program-derived funds to improve operations, to fund the logical expansion of our CDC into contiguous "local development" areas and to use state-generated funds to further support local economic development activities in each state that we operate. As a regulated non-profit certified development company we must meet strict non-profit IRS guidelines, prepare Audited Financial Statements for SBA review and meet all SBA regulations. The inclusion of the "Use of Excess Funds" section of the proposed regulations re-affirms what has been the "best" practice of Granite State Development Corporation/New England Business Finance and other CDCs since certification.

Loan Committee Participation

A number of regulations governing the 504 program, some recent and some written more than a generation ago, have constrained program growth. These regulations have discouraged CDCs from providing financing to small businesses by requiring productive CDCs to establish redundant bureaucracies when they cross state lines. The proposed legislation takes a giant step forward by allowing multi-state CDCs to have a single loan committee with required participation by at least one member from the state in which the loan is made. For multi-state CDCs, the consolidation into a single loan committee will allow the CDC to operate more efficiently without diminishing the critical loan review process.

<u>Aggregate Accounting</u>

The old regulations never contemplated that there would be LEAs or multi-state operations. Current multi-state CDC policies have resulted in an inefficient, wasteful utilization of limited CDC resources for the small number of CDCs operating on a multi-state basis. As stated previously in my testimony, both the IRS and the SBA require CDCs to meet strict compliance guidelines and regulations. The proposed regulations allowing for aggregate accounting for multi-state CDCs is substantially more efficient and will not impair the ability of the SBA to provide CDC oversight or to audit 504 Loan Program activities. Again, this is one of those “it just makes sense” enhancements to the regulations.

Closing Observations

Over the last 25 years, I have spent a great deal of time personally and professionally agonizing over what would make this great economic development program even better. Through the intervening years, I have experienced regulations that have been good for the program and those that have presented challenges. The proposed legislation is some of the best, if not the best, work done to date to clarify certain sections of the law while providing enhancements that are timely, efficient and forward looking. Although I have chosen to discuss certain specific sections of the legislation, I support the proposed legislation in its entirety.

Madame Chair, Ranking Member Kerry, and members of the Committee, I want to thank you for allowing me to share my thoughts on this significant legislation that will allow economic development professionals like me to do a better job of helping our clients, America’s Small Businesses, in accessing the capital they need to expand and create jobs.